Repurchase Agreements — Benefits, Risks and Controls

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A repurchase agreement (repo) is an agreement between two parties whereby one party (the cash borrower) sells the other party (the cash lender) a security at a specified price with a commitment to buy the security back at a fixed time and price. In return, the cash lender provides the borrower a cash loan collateralized by the securities the borrower sold to — and will repurchase from — the lender. Maturities can vary from overnight to a year, with the longer-maturity repos commonly referred to as “term” repos. Repurchase agreements provide important benefits to each of the parties to a repo transaction. For the broker-dealers that constitute a large majority of the cash borrowers, repos provide low-cost funding they can use to finance the marketable securities on their books. For the lenders — money market funds, insurance companies and other institutions with significant amounts of cash at their disposal — repos often provide better returns than many other short-term debt investments.

Repos are particularly attractive to the managers of money market funds because they offer three distinct benefits:

- **Liquidity** — Repos allow the managers to invest cash overnight, making them a critical component in their effort to manage liquidity. The size of the market and supply of repos also provide for strong liquidity.

- **Yield advantage** — Repos have historically provided additional yield as compared to traditional money market instruments, such as Treasury bills, time deposits or agency discount notes. The yield advantage depends on such factors as the repo’s maturity date and its credit quality.

- **Flexibility** — The daily principal amount of repos can be adjusted up or down as fund cash flows dictate and transactions can be conducted late in the day.

Two basic types of repurchase agreements are the bilateral repo and the tri-party repo. With a bilateral repo transaction, a pension fund, insurance company or other cash lender buys securities from a cash borrower on the condition that the borrower will repurchase the securities at an agreed-upon price and date. On the trade date, the borrower delivers the securities to the cash lender, who simultaneously pays the cash to the borrower. The process is reversed on the repurchase date, when the lender returns the securities to the borrower, and the borrower, in turn, transfers the borrowed funds back to the lender with interest.

**Mechanics of a bilateral repurchase agreement**

The second type of repo — and one utilized by BofA Global Capital Management and other cash asset managers — is the tri-party repurchase agreement. A tri-party repo differs from a bilateral repo in that a third party — a tri-party custodian bank — acts as an intermediary between the borrower and the lender. The tri-party custodian bank holds the collateral — the
securities sold by the borrower to the lender. A tri-party repo creates operational efficiencies such as transaction settlement, custody of securities and collateral valuation.

Mechanics of a tri-party repurchase agreement

Whether bilateral or tri-party, repos are designed such that the lender takes possession of the collateral if a counterparty fails to meet its obligations under the repurchase agreement. While counterparty selection and collateral requirements provide protection, repos remain subject to counterparty risk.

If a counterparty defaults, a loss may be realized on the sale of the underlying security to the extent that the proceeds from the sale and accrued interest of the security are less than the resale price, including interest, provided in the repurchase agreement. Moreover, should a counterparty declare bankruptcy or become insolvent, a fund may incur delays and costs in selling the underlying security.

BofA Global Capital Management seeks to mitigate counterparty risk by providing credit and portfolio oversight through controls and reviews that include:

- **Credit review process** — BofA Global Capital Management’s assessment of credit quality includes counterparty evaluations in which all counterparties must be vetted and approved by the firm’s credit review committee. If the counterparty is not on the approved list, BofA Global Capital Management will not execute a repurchase agreement with it (even if it posts strong collateral).

- **Collateral requirements** — BofA Global Capital Management’s collateral requirements are designed to protect fund investors should a counterparty default:
  - The value of the security must be equal to or greater than the value of the repo itself (typically 102% but can be up to 115% of the repo value depending on the collateral’s credit quality).
  - Repo positions must have first claim and priority lien on the collateral.

- **Operating controls** — BofA Global Capital Management conducts periodic reviews to verify that the requirements noted above are met and that the appropriate legal agreements are in place to protect a fund’s interests in the collateral.

BofA Global Capital Management believes its credit review process, collateral requirements and operating controls are well designed to manage counterparty risk associated with repo transactions. As such, BofA Global Capital Management continues to believe that repos are an appropriate investment vehicle for the portfolios it manages.
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